Finance and Policy Committee

Date: **17 October 2012**

Item 7: **Group Treasury Activities – Part 1**

This paper will be considered in public

1 Summary

1.1 The purpose of this paper is to:

(a) provide an update on Group Treasury's activities for the six months period between 1 April and 30 September 2012;

(b) update the Committee on the proposed plans to implement the agreed Treasury Management Strategy 2012/13 (TMS 2012/13);

(c) seek approval for new issuance under TfL's Medium Term Note Programme (MTN Programme); and

(d) seek approval for financial derivative investment transactions to hedge against the effect of movements in underlying market interest rates on the cost of TfL's planned borrowing.

1.2 A paper is included on Part 2 of the agenda, which contains exempt supplemental information and documentation. The information is exempt by virtue of paragraph 3 of Schedule 12A of the Local Government Act 1972 in that it contains information relating to the financial affairs of TfL. Any discussion of that exempt information must take place after the press and public have been excluded from this meeting.

2 Recommendations

2.1 The Committee is asked to:

(a) note the paper;

(b) in relation to the Borrowing Strategy 2012/13 (included in the Treasury Management Strategy 2012/13) approve:

(i) the issuance by TfL of Notes under its MTN Programme between the meeting of the Committee held on 17 October 2012 up to 31 March 2013; and

(ii) pursuant to section 49 of the Transport for London Act 2008 ("the Act") and the TfL Group Policy relating to the Use of Derivative Investments, Transport for London Finance Limited (as a qualifying TfL subsidiary for the purposes of the Act) entering into derivative investments in the form of gilt locks or interest rate swaps to fix the reference Gilt rate for any planned borrowing, for the purposes of the prudent management of the financial affairs of TfL and its subsidiaries, and limiting the extent to which one or more TfL bodies will be affected by changes in interest rates;

provided that:

1 the Managing Director, Finance has approved such issuance and/or derivative investment;

2 such issuance and/or derivative investment are otherwise in accordance with any relevant parameters set out in the Treasury Management Strategy 2012/13, the TfL Group Policy relating to Derivative Investments, and in this paper;

3 the Managing Director, Finance, consults with as many Members of the Committee that are available, on:

a. the proposed term and amount of such Note issuance and/or derivative investment in advance of such Note issuance and/or derivative investment; and

b. the need for any Supplemental Prospectus prior to the proposed Note issuance;

(c) in relation to the Investment Strategy 2012/13 (included in the Treasury Management Strategy 2012/13) approve the entry by TfL into Repurchase Agreements with one or more counterparties on TfL's Approved Investment List;

(d) subject to the approvals being given in paragraph (b) and/or (c) above, delegate authority to the Commissioner, Managing Director, Finance, General Counsel, the Chief Finance Officer and the Group Treasurer and Subsidiaries so that any one of them may:

(i) approve, authorise and agree the final terms of the transactions relating to such Note issuance(s), Repurchase Agreements and/or derivative investment(s) and or other documentation relating thereto (including, without limitation, all agreements, deeds, announcements, notices, contracts, certificates, letters, subscription agreements, supplemental prospectuses, or other documents);

(ii) authorise the agreement and execution (whether by deed or otherwise on behalf of TfL or any Subsidiary (as appropriate) of any documentation to be entered into in connection with the completion and implementation of such Note issuance(s), Repurchase Agreements or derivative investment(s) (including, without limitation, all agreements, deeds, announcements, notices, contracts, certificates, letters, subscription agreements, supplemental prospectuses, or other documents); and

(iii) do all such other things as they consider necessary or desirable to facilitate the execution and implementation of such Note issuance(s), Repurchase Agreements and/or derivative investment(s); and

(e) note that the Committee will be notified of any issuance under the MTN Programme and/or derivative transaction at the meeting following such issuance and/or derivative transaction.

2.2 The following Subsidiaries have delegated authority: Subsidiaries of TfL including Transport Trading Limited and any other subsidiary of Transport Trading Limited and any of the directors of the relevant company shall be authorised to act for and on behalf of that company.

3 Background

3.1 On 15 March 2012, the Board approved the TMS 2012/13 (which includes an Investment Strategy 2012/13, a Borrowing Strategy 2012/13 and a Risk Management Strategy 2012/13) and established the following strategic objectives for Group Treasury:

(a) to undertake treasury management operations with primary regard for the security and liquidity of capital invested with reference to the Guidance issued by the Department for Communities and Local Government;

(b) to maximise the yield from investments consistent with the security and liquidity objectives identified above;

(c) to ensure that sufficient cash is available to enable TfL to discharge its financial obligations when they become due, in accordance with approved spending plans;

(d) to undertake treasury management activity having regard to Prudential Indicators;

(e) to secure TfL's funding requirements by accessing the most cost efficient source of finance, while ensuring TfL has flexibility and sufficient alternatives not to be dependent on any particular source; and

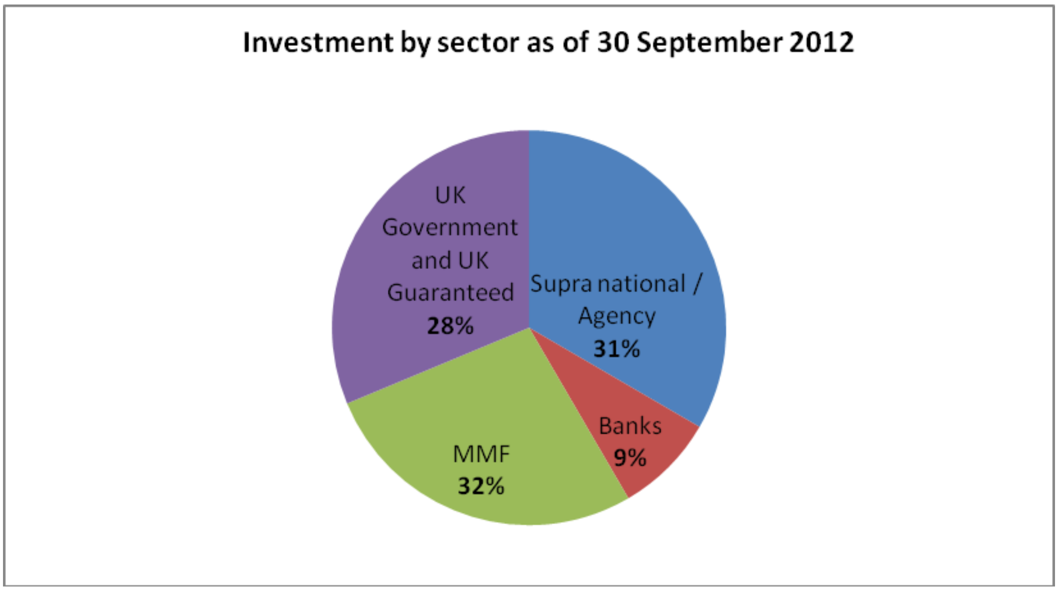
(f) to exercise TfL's statutory power relating to risk management to achieve greater value for money through reducing costs or protecting revenues, reducing volatility / increasing certainty in the Business Plan and to holistically manage financial risks across the whole of TfL.

3.2 This paper provides an update on TfL's investment, borrowing and risk management activity in the half-year to 30 September 2012 in pursuit of these strategic objectives. Sections 4-6 also set out the planned activity in each area for the remainder of the financial year 2012/13.

4 Investments Update

4.1 As at 30 September 2012, TfL had £3.2bn of cash under management (including £1.3bn of cash ring-fenced to fund the construction of the Crossrail project). The allocation of these funds is summarised in Chart 1.

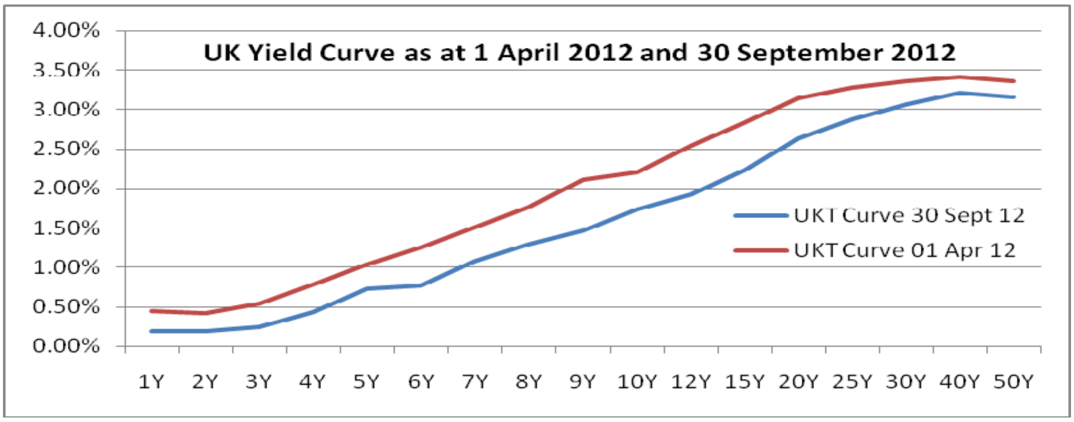
Chart 1



4.2 The share of cash in bank deposits has been actively reduced over time in response to the deterioration of the credit quality of a number of financial institutions.

4.3 As a result of continued economic slowdown both in the UK and Europe and quantitative easing, short term rates have continued to fall. UK rates have been pushed downward as a result of continued risk aversion and the flight to quality. As a result, Sterling yields are down substantially from the beginning of the year and are expected to reduce further as a result of a predicted further cut in the Bank of England base rate in Q1 2013. Chart 2 shows the UK Government yield curve as at 1 April 2012 and the same curve at 30 September 2012.

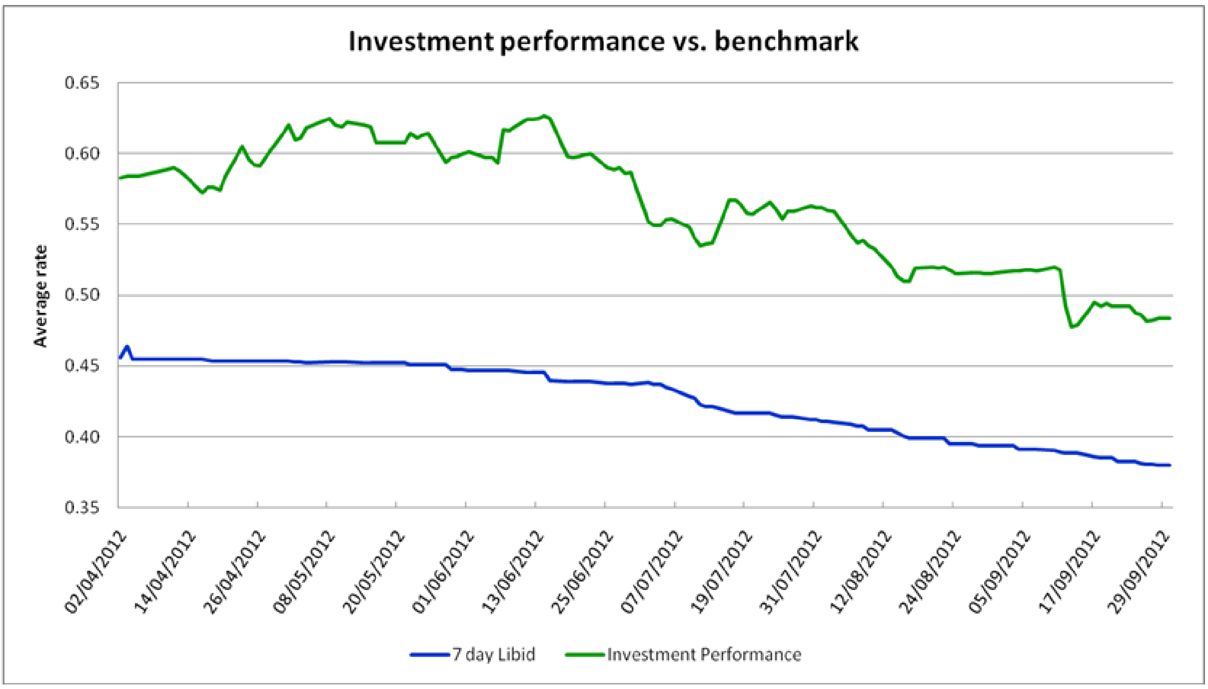
Chart 2



4.4 Germany has seen rates fall into negative territory as investors seek safe haven. A number of Money Market Funds ("MMF") in Europe are considering how the structure of their funds may need to change if yields continue to fall and the aggregate return of the fund turns negative. TfL is monitoring closely the developments in Europe and has been in discussion with the MMFs on the Approved Investments List about the issue.

4.5 The return on TfL's cash investments has decreased in line with market rates. Seven-day LIBID has decreased since 2 April 2012, from 0.46 per cent to 0.38 per cent, while TfL's investment returns have decreased from 0.58 per cent to 0.48 per cent. Chart 3 shows the movements in the return on cash and LIBID over the half-year to 30 Sept 2012.

Chart 3



4.6 TfL’s year-to-date average yield is 0.57 per cent, 15bps above benchmark, with an average of 60 days–to-maturity.

4.7 No breaches of the TMS 2012/13 in respect of TfL’s investments have occurred in the year to date.

Investment Plans

4.8 No changes are proposed to the Investments Strategy 2012/13 approved in March 2012.

4.9 TfL is developing its analysis in respect of long-term cash forecasting and is in discussion with Crossrail Limited about the Crossrail project cash forecasts. This analysis is expected to result in a proposal from Crossrail for investments of longer tenor than are currently permitted under the Investment Strategy which will be brought to the Committee and the Board for approval in due course.

4.10 In response to continued reductions in returns on UK Government debt, TfL is proposing to enter into Repurchase Agreements with some of the counterparties on TfL’s Approved Investment List and it is proposed that the entry into such agreements be approved. A detailed explanation of Repurchase Agreements is included at Appendix 1 to this paper. Repurchase Agreements now offer a return around 15bps higher than equivalent UK Government debt and are effectively loans to TfL’s counterparties which are secured on the counterparties’ holdings of securities acceptable to TfL (i.e. UK Government debt). Any Repurchase Agreements will be treated as investments with the counterparty in question and undertaken within the existing approved limits on investments with that counterparty. TfL will utilise more of the available investment limit with each bank to the extent that investment is secured on UK Government Debt. TfL retains the ability to enter into Repurchase Agreements as a borrower, if necessary, in order to achieve short-term liquidity from longer-term investments without the need to sell the longer-term investment (which could result in capital loss).

5 Borrowing Update

5.1 In April 2012, TfL completed the scheduled drawdown of £200m under the existing £1bn Crossrail loan facility with the European Investment Bank (EIB) at a pre-agreed fixed rate, set in October 2009. Further drawdowns under this facility are scheduled for April 2013 and April 2014.

5.2 In July 2012 TfL took advantage of positive market conditions to issue two £500m bonds, thereby achieving the long-standing objectives of re-establishing TfL’s presence in the capital markets (providing an additional borrowing source and generating cost savings compared to the Public Works Loan Board (PWLB) equivalent) and replacing a portion of TfL’s short-term borrowing with longer-term debt:

(a) On 12 July 2012, TfL successfully issued a £500m 30-year bond at an annual coupon of 3.875 per cent (3.896 per cent semi-annual yield) and a spread over the benchmark UK Gilt of 98bps, which equates to a saving of 16bps versus the equivalent 30 year PWLB annual rate of 4.09 per cent (4.06 per cent semi-annual rate). Total savings over the life of the bond will amount to approximately £25m (undiscounted). The bond was issued at a rate 63bps lower than expected in the Business Plan, allowing £3.1m p.a. of savings to be released.

(b) In response to strong investor demand, on 31 July 2012, TfL successfully issued a £500m 10-year bond at a coupon of 2.25 per cent (with a semi annual yield of 2.338 per cent) and a spread over the benchmark UK Gilt of 88bps, which equates to a saving of 36.2bps against the equivalent 10 year PWLB rate of 2.70 per cent. That equates to a saving of £18m (undiscounted) over the 10 years compared to borrowing from PWLB. The bond was issued at a rate 77bps lower than expected in the Business Plan, allowing £3.85m p.a. of savings to be released.

5.3 Both bonds are performing well in the secondary market, reflecting further unmet investor demand for TfL’s bonds. The 30-year bond is currently trading 75-85bps over the benchmark UK Gilt, whilst the 10-year bond is trading at approximately the issuance spread. The secondary performance of the first bond was instrumental in achieving the more advantageous pricing of the second bond.

5.4 The TMS 2012/13 provides that, where existing debt is being refinanced, new borrowing may be undertaken in advance of repayment of the existing debt and that this may lead to a temporary increase in aggregate debt levels to above the Operational Boundary, provided TfL remains within the legal limit on its liabilities at all times (the Authorised Limit).

5.5 The two bond issues in part represent the refinancing of existing Commercial Paper issued to repay long-term Tube Lines Finance PLC debt in 2011/12. Following the second bond issue, aggregate debt levels were above the Operational Boundary (broadly speaking, TfL’s expected debt levels given the aggregate incremental borrowing agreed with the Department for Transport in any one year) while remaining within the Authorised Limit. Both the Operational Boundary and Authorised Limit were approved by the Board and established by the Mayor in March 2012. TfL’s aggregate debt is returning to expected levels as Commercial Paper falls due for repayment and is not replaced.

5.6 The combined effect of borrowing transactions completed in the year to date are reflected in Charts 4 and 5, which show TfL’s debt outstanding as at 31 March 2012 and 30 September 2012.

Chart 4

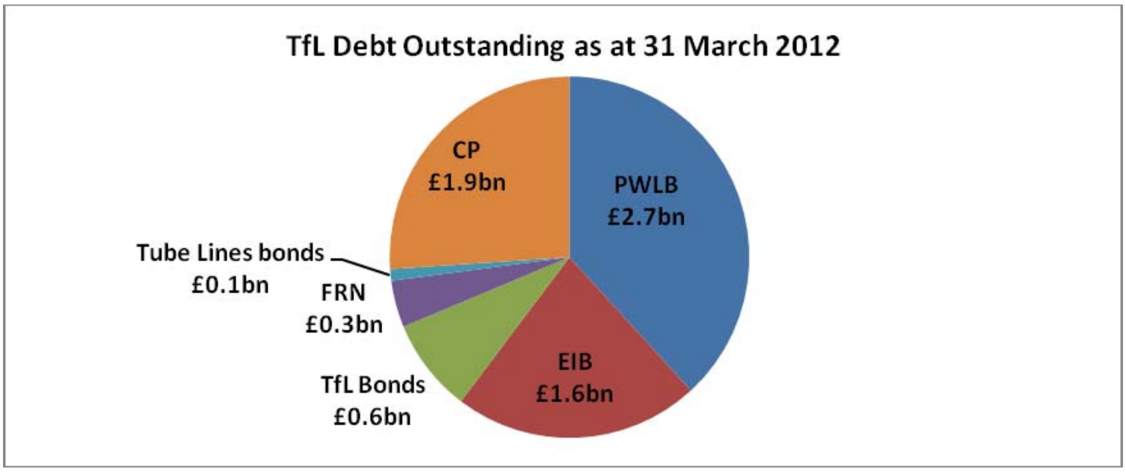
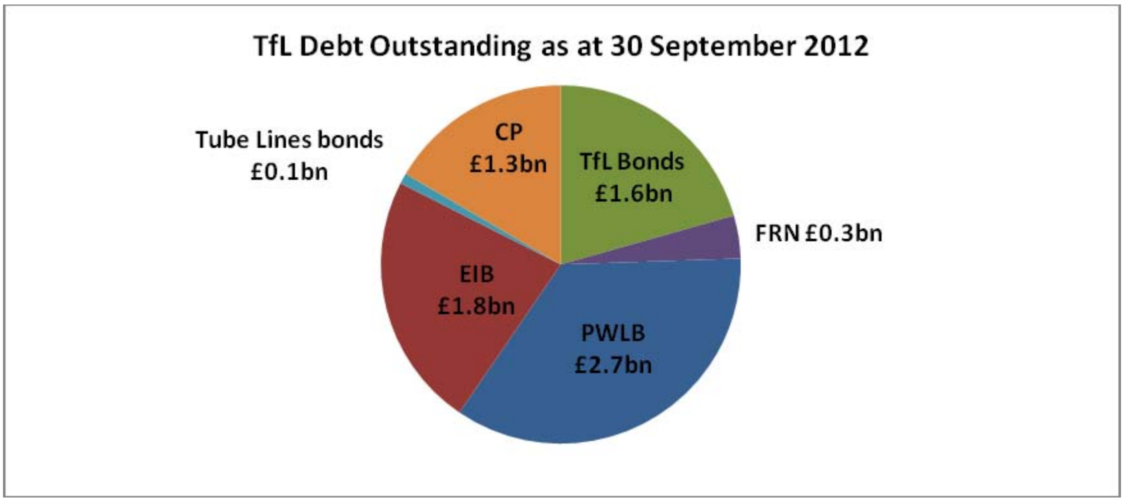


Chart 5



5.7 As at 31 March 2012, TfL had £7.1bn of debt, of which approximately £2.2bn was short-term borrowing (comprising £1.9bn of Commercial Paper and £300m of a one-year Floating Rate Note (FRN)). The weighted average interest rate on TfL's debt was 3.44 per cent (weighted average life of 16.3 years). As at 30 September 2012, TfL had £7.765bn of debt outstanding, of which £1.6bn was short-term (£1.3bn Commercial Paper and £300m one-year FRN). The weighted average interest rate on TfL's debt was 3.74 per cent (weighted average life of 19.3 years).

5.8 The increase in the weighted average interest rate reflects the increase in the weighted average life of TfL's debt. This increase in average life largely represents the end of the temporary benefit that resulted from buying back the long-term Tube Lines Finance PLC debt and funding that buy-back with Commercial Paper pending the issuance of longer-term debt. This use of Commercial Paper resulted in a £29m saving against budget in the current year.

5.9 On 23 August 2012, TfL issued the updated documentation for its £5bn MTN Programme. The update of the Base Prospectus was required to enable TfL to retain its access to the capital markets. The Base Prospectus is publicly available on tfl.gov.uk.

5.10 Following the announcement in the March 2012 Budget, in August 2012 the Department for Communities and Local Government published the arrangements under which borrowers providing improved information and transparency on their locally-determined long-term borrowing and associated capital spending plans will be able to access a discounted rate of Gilts + 80bps on borrowing from the PWLB. Borrowers are required to complete a form annually which provides a forecast of borrowing requirements and brief details of the capital investments being financed. TfL completed this form as required and expects to have its access to the discounted PWLB rate confirmed in due course and to have access to the discounted rate from 1 November 2012. Access to the discounted rate reduces the cost of TfL's lender of last resort however, at present, TfL expects to be able to borrow in the capital markets more cheaply than the discounted PWLB rate. The Government is also still considering the potential for an independent body to facilitate the provision of PWLB lending at a further reduced rate, to authorities demonstrating best quality and value for money.

5.11 There have been no breaches of the TMS 2012/13 in respect of TfL's borrowing in the year to date.

TfL Credit Rating

5.12 At least once a year TfL holds a general update meeting with each one of the three Rating Agencies that rate TfL's short and long term debt. Following such meeting, each Rating Agency re-assesses the entity's credit rating and outlook. Table 1 sets out TfL's current credit ratings:

Table 1

	Standard & Poor's	**Moody's**	**Fitch**
Long-term rating	AA+	Aa1	AA+
Outlook	Stable	Negative	Negative
Short-term rating	A-1+	P-1	F-1

5.13 Moody's and Fitch placed TfL on negative outlook in January and March 2012 respectively. The rating action reflects the two agencies' revision of the outlook on the UK's rating to negative. Other entities close to the UK Government, for example Network Rail, were placed on negative outlook at the same time. A decision on whether to maintain the rating or proceed with a downgrade is expected to be taken by the two agencies within the next 12 to 24 months. The change in outlook has not had an adverse effect on TfL's ability to borrow at attractive interest rates. A downgrade of the UK would however likely lead to a downgrade of TfL's credit rating.

5.14 Standard & Poor's confirmed TfL's credit rating and its stable outlook in May 2012.

Investor Relations

5.15 Over the past twelve months, TfL has pursued a strategy of establishing closer relationships with its existing and potential investors, as well as with the broader banking community. In the financial year 2011/12, TfL carried out a series of meetings with potential investors in Europe and Asia to explain TfL's operational, institutional and financial framework. These meetings were critical in the success of the bond issuances launched in July 2012, as they gave investors an opportunity to fully appreciate the strengths of the TfL's credit.

5.16 In June 2012, TfL and Crossrail hosted a "Bank Day" to offer a large number of financial institutions the opportunity to learn about TfL's investment programme and pipeline of future projects. Representatives of over 25 financial institutions attended the event and confirmed that the presentations were extremely useful to understand the large extent of TfL's activities.

5.17 Group Treasury is in the process of introducing further improvements in the relevant TfL web-pages to ensure that existing and potential investors have easy access to key information on TfL and it is planning to host other events for the financial community in the future. Investors have commented positively on the quality of TfL's Investor Relations pages compared to those of other issuers.

Proposed Bond Issuance and Derivative Investments

5.18 Under the Borrowing Strategy 2012/13, the Committee's approval is required for any new debt issuance under the MTN programme.

5.19 In July 2012, the Committee approved issuance of new notes under the MTN programme during the period between the July and October 2012 Committee meetings, subject to the Managing Director, Finance discussing the proposed term and amount of any such notes and associated Supplementary Prospectus(es) with members of the Committee who were available .

5.20 This delegation proved critical in enabling TfL to access the market promptly when market conditions were favourable. Without this, TfL might have been unable to access the markets at the end of July 2012.

5.21 Given the continued volatility and uncertainty of the financial markets and the criticality of being able to access the markets promptly when favourable windows arise with a transaction suited to demand conditions at that time, it is proposed that a similar delegation be given for the period between 17 October 2012 and 31 March 2013.

5.22 As TfL already had in place hedging (Gilt Locks) in respect of the two July Note issuances it was not necessary in July to extend any new hedging arrangements. There is currently no further hedging in place for subsequent issuances and therefore it is proposed that delegated authority be extended to the hedging of the proposed bond issuance.

6 Other Activities

Systems

6.1 The Treasury Management System continues to be developed and now holds comprehensive credit rating information, more automated cash forecasting tools, an investment dashboard report, highly controlled dynamic and Board investment limits and automated links to ReVal (TfL's derivative accounting and valuation system).

6.2 Group Treasury implemented a money market fund portal allowing all money market funds to be transacted electronically and to give greater access to historical rates, portfolios and past deals.

6.3 Tube Lines Limited was added to the TfL wide HSBC electronic banking platform allowing them to make same day value payments (i.e. CHAPS) in a secure manner.

Cash Collection

6.4 Group Treasury set up bulk cash collection and deposit facilities for the Emirates Air Line at late notice. These facilities normally take approximately ten days to put in place and they were set up within 48 hours allowing the Air Line ticket offices to operate efficiently and securely from day one.

List of appendices to this report:

Appendix 1: Description of Repurchase Agreements

A paper on Part 2 of the agenda contains exempt supplemental information.

List of Background Papers:

Treasury Management Strategy 2012/13

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Appendix 1

Description of Repurchase Agreements

1.1 A Repurchase Agreement ("Repo") is an agreement to enter into two simultaneous transactions, whereby one counterparty sells securities to another counterparty and then agrees to repurchase the securities at a later date.

1.2 Transactions are fully collateralized by security of choice. TfL would only enter into transactions collateralized by UK Government securities.

1.3 In a Repo the dealer lends securities in return for borrowing cash, and a Reverse Repo sees the dealer borrowing securities and lending cash. If TfL has cash to invest, it would enter into a Repo with the dealer, the dealer would lend UK Government securities to TfL and buy them back at a later date. If TfL enters into a Reverse Repo, it would be lending UK Government securities already held as an investment to a dealer, with an agreement to buy them back at a later date.

1.4 Transactions are governed by the Global Master Repurchase Agreement (GMRA). It is proposed that TfL negotiate and enter into GMRAs with each financial institution with which it may enter into a Repo transaction. This is the industry standard form documentation which is adapted to meet the requirements of the parties (including by attaching annexes specifying which types of securities can be the subject of a Repo between the parties).

1.5 Transactions would settle based on a Tri-Party arrangement. Similar to the process when TfL invests in T-Bills or Gilts, settlement would occur through TfL's Crest custodian account. The tri-party custodian facilitates the flows of Repo Securities (which are held as collateral on the Repo Buyer's behalf) and cash between the counterparty and TfL, and serves as an independent pricing source for the transaction. TfL maintains principal protection in the form of collateral held in the account in the event of a counterparty default or insolvency. To ensure TfL is fully collateralized, the UK Government securities are valued daily and the actual securities held are either increased or decreased to match the daily market value. This process is performed by the tri-party custodian, Crest. As a result TfL's exposure to the counterparty is limited to one day's movement in the securities value. The amount of this exposure depends on the duration of the collateral held, but as an example a 25 basis point increase in rates on a £100m 10 year gilt would equal a loss in value of £2.3m, or 2.3 per cent.

1.6 The counterparty exposure is limited to a 1 day movement in rates as the collateral is replenished daily.